High Yield Strategy

Newfleet
ASSET MANAGEMENT
A Virtus Investment Partner

Sector Assessment

FUNDAMENTALS
Fundamentals continue to show signs of improvement. The issuer-weighted default rate, 4.7% at quarter-end, may have peaked as Moody's expects it to drop to 3.0% over the next 12 months.

TECHNICALS
Despite higher-than-usual levels of issuance and negative flows, the market has been able to stay in balance as the bulk of the new issuance has been for refinancing purposes.

VALUATIONS
Valuations are on the richer side, but high yield may yet grind tighter based on the expectation for fewer defaults, accommodative global monetary policy, and an improving economic backdrop.

Important Developments this Quarter

Overview: Post-election expectations of faster economic growth and rising inflation continued into the first quarter as optimistic investors waited for clarity on President Trump's fiscal policies. As the quarter progressed, support for the "Trump trade" weakened as the new administration experienced bumps in the road with its aggressive agenda and visible opposition. In March, the Federal Reserve raised rates for the second time in three months, the Brexit process formally began, and crucial European elections loomed closer.

Europe: Political and economic developments in Europe captured attention during the first quarter. On March 29, nine months after voting to leave the European Union, Prime Minister Theresa May triggered Article 50 of the Lisbon Treaty to start the two-year process for the UK's exit from the 60-year-old alliance. As the UK embarks on a path of complex and surely contentious negotiations, other European nations (and the Continent as a whole) are bracing for elections that will test the strength of right-wing populism and euro skepticism. While the Netherlands rejected its anti-European candidate in March, the more consequential French polls follow in late April/early May, and German elections will take place in September. Against this backdrop of political uncertainty, economic recovery in Europe is underway. The fear of deflation has diminished and positive economic data are emerging, albeit unevenly across the eurozone. The European Central Bank (ECB) held rates steady in March and announced no additional stimulus. There is a growing conviction that the end of quantitative easing is in sight, especially because the ECB is running out of options in terms of bonds it can buy.

Federal Reserve: While accommodative monetary policy persists in Europe, as well as in Japan, the Fed acted on its stated "confidence in the robustness of the economy" by raising its benchmark rate another quarter of a percentage point to a range of 0.75% to 1.0%. The probability of the move reached nearly 100% as the Fed's March meeting drew closer. Labor market conditions and inflation both are approaching the decision-making body's target levels. Chair Janet Yellen continued to emphasize a gradual approach to rate hikes with two more projected in 2017.

U.S. Economy: The U.S. economy has indeed been resilient over the past few months. GDP increased at an annual rate of 2.1% during the fourth quarter of 2016, ahead of expectations though short of its 3.5% level in the third quarter of 2016. Labor market conditions remain firm, with 4.7% unemployment at the end of February. Though long-term inflation expectations have eased as a result of lowered expectations for fiscal stimulus, realized inflation measures have been trending higher. Core PCE (personal consumption expenditures ex food and energy), the Fed's preferred gauge, reached 1.8% in February and is approaching the 2% goal. Consumer confidence and the housing sector remain supportive.

Treasuries: The yield curve flattened over the quarter, with rates higher on the front end of the curve and relatively unchanged on the long end. The yield on the 10-year U.S. Treasury ended the quarter at 2.39%, modestly below the 2.45% yield at year-end 2016. Having surged in the aftermath of the presidential election, the benchmark yield was in a holding pattern for much of the first two months of 2017 as investors reevaluated the pace and likelihood of Trump's growth-oriented fiscal policies. Rising expectations of a March rate hike pushed the 10-year bond to a three-year high of 2.63%. Yields subsequently retreated on

U.S. TREASURY YIELDS

	12/31/15	12/31/16	3/31/17
2 year	1.05%	1.19%	1.26%
5 year	1.76%	1.93%	1.92%
10 year	2.27%	2.45%	2.39%
30 year	3.02%	3.07%	3.01%

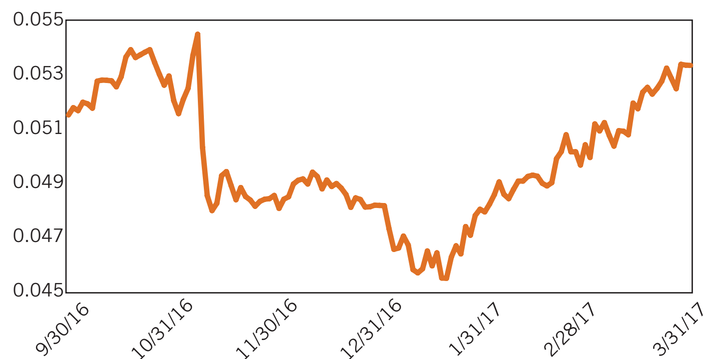
Source: Bloomberg L.P.

continued

the Fed's message of gradual hikes. This was reinforced by the failure of Congress to repeal Obamacare, and its implications for accomplishing other items on Trump's pro-growth agenda. The attractiveness of the U.S. bond market relative to other developed markets like Germany, Japan, and the UK has helped to keep a lid on U.S. yields. The demand for safe-haven assets amid the ebb and flow of political risk in Europe, namely France, has also benefited U.S. yields.

U.S. Dollar: The U.S. dollar declined steadily over the quarter in the wake of falling bond yields, disappointment with the progress on Trump's fiscal stimulus plans, and the Fed's dovish posture on future rate moves. The Bloomberg Dollar Index (a basket of 10 leading currencies against the U.S. dollar) ended the quarter at 1223.05, modestly above its pre-election level and well below its post-election high on January 3 of 1277.53. Perhaps most symbolic of the new administration's struggle to actualize its campaign pledges was the strengthening of the Mexican peso versus the U.S. dollar. During the election season, the peso rose and fell with candidate Trump's standing in the polls. This reflected his hardline stance on tariffs, immigration, and the future of NAFTA. At the end of the first quarter of 2017, the peso was the top-performing currency in the world (+10.8%) and had recouped its losses against the dollar.

U.S. DOLLARS PER MEXICAN PESO



Source: Bloomberg, L.P.
Performance data shown represents past results.

Oil: Until early March, oil had hovered around $55 per barrel following OPEC's November 30, 2016 agreement to curb output in support of prices. Reports of record-high levels of U.S. output, however, reignited worries of an oil glut. Despite a drop in production and strong compliance with the OPEC accord among participating countries, fears that U.S. oil production could overwhelm OPEC's cuts drove prices down. On May 25, OPEC will decide whether to extend the agreement, which went into effect for six months on January 1. Brent Crude, the international benchmark, touched a low of $49.92 per barrel before rising at quarter-end to $52.71 on encouraging signals of an extension from the cartel.

Global Fixed Income Performance

The broader U.S. bond market, as represented by the Bloomberg Barclays U.S. Aggregate Bond Index, returned 0.82% for the first quarter. Most spread sectors outperformed U.S. Treasuries during the quarter and spreads tightened. Longer duration assets and lower quality within each sector were key drivers of performance.

Emerging markets was the best performing sector for the quarter as fears of the impact of a Trump presidency on these markets subsided. The sector benefited from a weaker U.S. dollar, expectations of gradual rate hikes by the Fed, and the failure to materialize (or delay) of Trump's protectionist policy pledges. Relative stability in commodities and in China also contributed to the positive sentiment. External factors aside, emerging market fundamentals in the aggregate have been improving, and growth may be returning.

High yield corporates also generated strong performance for the quarter, benefiting from the risk-on rally that has prevailed since the election. The sector also got a boost from negative net issuance, improving fundamentals, and global accommodative monetary policy. In a reversal from last quarter and full-year 2016, metals & mining and energy were among the laggards. Retail was the only sector to post a negative return. Lower quality continued to outperform higher quality.

FIXED INCOME SECTOR PERFORMANCE

Sector	Q1 2017
Emerging Market	4.2%
High Yield Corporates	2.4%
Investment Grade Corporates	1.2%
High Yield Bank Loans	1.0%
Commercial Mortgage-Backed	0.9%
Bloomberg Barclays U.S. Aggregate Bond Index	0.8%
U.S. Treasuries	0.7%
Agency Mortgage-Backed	0.5%

Performance as of March 31, 2017.
Sources: J.P. Morgan: Emerging Markets, High Yield Corporates, High Yield Bank Loans; Bloomberg Barclays U.S. Aggregate Bond Index: All other sectors.
Performance data shown represents past results.

High Yield Sector Review

The **high yield sector** returned 2.70% in the first quarter of 2017 as measured by the strategy's benchmark, the Bloomberg Barclays U.S. High Yield 2% Issuer Capped Bond Index.

continued

> Lower quality continued to lead the charge in the first quarter much like it has since the onset of this rally on February 11, 2016. The larger the allocation to the lowest credit tiers of the high yield market, the better the performance. A breakdown of the index by credit quality demonstrates this: BBs, 2.06%; Bs, 2.52; CCCs, 4.66%; Ca-Ds, 8.87%; and not rated, 5.46%. From an industry perspective, energy and metals & mining no longer drove market performance, as other industries took leadership roles. Oil field services (+4.83%), industrial other (+4.62), healthcare (+4.58%), transportation services (+4.49%), and electric utilities (+4.37) were the top-performing industries for the quarter. Retail was the only industry to deliver a negative return during the period.

> From a **fundamentals** perspective, high yield is in a good place. The headline default rate has begun its descent from the higher levels attributed to last year's defaults within the energy and metals & mining space. The headline number at quarter-end was 4.7%, down a full 100 basis points from the prior quarter. Stripping out the two troubled industries, the default rate was de minimus for the rest of the market. The duration of this current credit cycle has extended well beyond prior cycles within the historical context of the modern-day high yield market. Wide open capital markets have provided a lifeline, especially during the early stages of 2016, when the fear of a global recession was rampant, along with the belief that most commodity issuers were headed for bankruptcy.

> Top-line and bottom-line growth for the high yield issuer universe overall, though anemic, has continued to improve in sync with the underlying economy. The rating agencies have taken notice as the upgrade/downgrade ratio went from a dismal 0.3x at the end of the first quarter of 2016 to an impressive 1.4x at year-end. The ratio was more balanced for the first quarter of 2017 at 1.0x based on issuer count. By dollar volume, the impressive trend continued at 1.3x. The high yield market may have just witnessed a mini credit cycle within an overall longer credit cycle, especially if the stabilization in commodity prices can hold. The next industry with the potential to crack would be the retail industry, but given its low weighting (2.93%) within the index, its impact on the overall default rate for high yield would be negligible.

> High yield **technicals** have not been as supportive as they were during the second half of 2016. The first quarter of this year has seen a larger than usual amount of new issuance as companies try to get their capital structures in place in case the Fed continues to move rates higher. This would make new

HOW THE STRATEGY PERFORMED

Contributors +

- **Industries:** The top four contributors were:
  - media-entertainment (issue selection), technology (issue selection), finance companies (issue selection), and consumer products (issue selection).
- **Out-of-index sectors:** The allocations to emerging markets high yield and investment grade corporates helped performance.
- **Issue selection:** The three best performers were:
  - Intelsat Jackson Holdings, SA, a communications satellite services provider, benefited from a proposed merger with OneWeb that will result in an equity infusion by backer SoftBank that will effect debt reduction.
  - Tenet Healthcare Corp. bonds rebounded strongly in the first quarter of 2017 on the failure of Congress to repeal and replace Obamacare, as well as favorable operating results.
  - Crossmark Holdings, Inc., a sales and marketing services company, rose on alleviation of lenders' concerns and the prospect of improving fundamentals.

Detractors −

- **Industries:** The bottom three contributors were:
  - cable-satellite (issue selection), healthcare (issue selection), and chemicals (issue selection).
- **Out-of-index sectors:** The allocations to structured product and bank loans detracted from returns.
- **Issue selection:** The three largest detractors were:
  - Walter Investment Management Corp., a diversified mortgage banking firm, fell on poor earnings driven by operational difficulties.
  - Concordia Healthcare Corp. declined on weak fourth quarter results and deteriorating operating results, in combination with ongoing challenges that include generic competition for a number of its North American products, currency headwinds, and National Health Service legislation that has the potential to materially change UK drug pricing and regulatory investigations.
  - Linn Energy was hit hard by the decline in oil prices during March. It underperformed other portfolio holdings given that it is common equity rather than a bond.

continued

debt more expensive. In addition, flows have continued their erratic pattern from last year, though the direction has been tilted more toward the negative (-$7.4 billion in flows year-to-date). The one saving grace so far this year has been the low count of fallen angels. This differs from the first quarter of 2016 when it seemed like the rating agencies were downgrading companies at a very rapid clip, especially those issuers in the energy and metals & mining segments of the market. There does appear to be a strong shadow bid, typical of any period of market weakness, which is consistent with research that suggests a considerable amount of money is sitting on the sidelines waiting for a pullback.

> **Valuations** continued to grind in tighter from the February 11, 2016 lows, with the average price at quarter-end of $100.93, yield to worst at 5.84%, and average option-adjusted spread at +383 bps. By comparison, the high yield index started 2017 with an average price of $99.80, yield to worst at 6.12%, and the average spread at +409 bps. High yield is still viewed as the best opportunity for investors looking for yield across the globe. Easy global monetary policy continues to suppress yields, and the Fed seems to be one of the only key central banks ready to put its foot on the brake pedal. With a historically low to negative correlation with interest rates and a modestly improving economic picture, high yield has been able to benefit from the strong technical demand, especially as buyers believed to be flush with cash put capital to work during periods of market weakness. High yield, from a valuation perspective, is on the richer side. However, history has shown that it can overshoot for long periods of time.

Strategy Performance and Positioning

The strategy benefited from strong issue selection within the higher credit quality buckets of the portfolio, as issues rated BB and BBB performed well during the first quarter. Even though higher quality underperformed within the index, our higher quality picks significantly outperformed. Our addition of credit risk also helped drive alpha to the portfolio, as did exposure to the sovereign, quasi-sovereign, and corporate areas within emerging markets. In particular, our rather large weightings to Argentina and some of the Argentinian local provinces were positive contributors, along with a sizable purchase of Petrobras debt. Energy prices were weaker for most of the quarter, but certain pockets within the energy high yield space delivered solid returns, including the midstream and oil field services segments. The strategy is slightly underweight to the midstream space and equally weighted to oil field services.

Similar to the pattern experienced for most of the past year, lower quality continued to outperform during the first quarter. The strategy was overweight the riskier credit tiers of the market, but the credits we owned did not perform as well as those in the respective rating categories of the index. A large portion of the underperformance came from issue selection within CCCs and within the basic materials industries, specifically chemicals, metals & mining, and paper.

Looking Ahead

The high yield market started off 2017 much like it ended 2016, by continuing its impressive winning streak. The problem currently for investors is that, no matter how much they like the space from a fundamental or technical perspective, valuations are at a much different level than they were in the first quarter of 2016. At that time, yields exceeded 10% and the market price was in the 80s. Now, with sub-6% yields and an index trading above par, the value proposition is not as strong. That is not to say high yield cannot continue to grind tighter, because it has shown in the past that it can. Improving fundamentals support tightening, and so do technicals, as any prolonged weakness in the market has seen buyers step in whenever internal valuation triggers are hit. From our vantage point, the extra compensation high yield offers for extending down in credit quality is not commensurate with the risk taken.

We still think there are pockets of value in the current market, but we need to be choosier than when the overall market yield is at much higher levels. Idiosyncratic risk is still very elevated, as witnessed whenever an issuer disappoints the market. However, high yield should still see a bid as long as the coordinated easing programs by the globe's most influential central banks remain in place and the Fed continues to raise rates at a measured pace.

There are a multitude of possibly market-moving events to watch, including key elections in Europe, the potential and perhaps inevitable quagmire associated with Trump's policy initiatives, the upcoming OPEC meeting to consider the extension of quotas, and geopolitical flashpoints in places like North Korea, Syria, Iraq, Yemen, and Afghanistan. Any weakness brought on by these events may find investors stepping in to provide support to the market and avert a steep selloff. Or market dynamics could flip and take risk out of favor.

continued

The **Bloomberg Barclays U.S. Aggregate Bond Index** is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS.

The **Bloomberg Barclays U.S. High-Yield 2% Issuer Capped Bond Index** is a market capitalization-weighted index that measures fixed rate non-investment grade debt securities of U.S. and non-U.S. corporations. No single issuer accounts for more than 2% of market cap.

The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and are not available for direct investment.

The commentary is the opinion of the subadviser. This material has been prepared using sources of information generally believed to be reliable; however, its accuracy is not guaranteed. Opinions represented are subject to change and should not be considered investment advice or an offer of securities.

Risk Considerations

Credit & Interest: Debt securities are subject to various risks, the most prominent of which are credit and interest rate risk. The issuer of a debt security may fail to make interest and/or principal payments. Values of debt securities may rise or fall in response to changes in interest rates, and this risk may be enhanced with longer-term maturities. **High Yield-High Risk Fixed Income Securities:** There is a greater level of credit risk and price volatility involved with high yield securities than investment grade securities. **Foreign Investing:** Investing internationally involves additional risks such as currency, political, accounting, economic, and market risk. **Industry/Sector Concentration:** A fund that focuses its investments in a particular industry or sector will be more sensitive to conditions that affect that industry or sector than a non-concentrated fund.

For more information on the Newfleet Fixed Income strategies, please contact:

Michael Sollicito, Chief Operating Officer
Newfleet Asset Management
T: 860.263.4859 | 877.332.8172
Michael.Sollicito@Newfleet.com
www.Newfleet.com

Past performance is not indicative of future results.

2056 5-17 © 2017 Newfleet Asset Management, LLC